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ABSTRACT

In this paper, the tools of legal and economic analysis are used to analyze the division of decision making authority between state and federal regulators of telecommunications policy. First, the principles of welfare economics are applied to the problem of defining appropriate jurisdictional boundaries. The results of this analysis are normative statements relevant to the problems of identifying a set of legal arrangements or policy rules to maximize economic welfare. Second, the way decisions are actually made is analyzed, and recent law cases resolving jurisdictional disputes arising under the 1934 Communications Act is reviewed. (16 footnotes) (EW)

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THE LAW AND ECONOMICS OF FEDERALISM IN TELECOMMUNICATIONS *

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In this paper we use the tools of legal and economic analysis to analyze the division of decisionmaking authority between state and federal regulators of telecommunications policy. We begin by applying the principles of welfare economics to the problem of defining appropriate jurisdictional boundaries. The implications of this analysis are thus normative ones relevant to the problem of identifying a set of legal arrangements or policy rules to maximize economic welfare. We then analyze the way decisions are actually made and survey the recent case law resolving jurisdictional disputes arising under the Communications Act.

Economic Analysis [1]

The economic view of how regulatory authority should be divided between federal and state jurisdictions has two essential characteristics:

(1) It treats the proper allocation of responsibility as primarily a question of maximizing economic welfare, that is, as a matter of evaluating costs and benefits, and selecting the policy that maximizes net benefits;

(2) It includes decisionmaking costs within its calculus, recognizing that there are potential economies from use of simple rules-of-thumb to make jurisdictional assignments;

In our paper we identify six important considerations for evaluating whether it is better to grant regulatory authority to the states or to the federal government in any particular instance:

(1) the comparative ability of different decisionmakers to produce and make use of relevant information;

(2) the comparative ability of decisionmakers to satisfy consumer tastes and preferences;

(3) the desirability of diversity and experimentation;

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1 Our analysis is informed by Richard Posner's "Toward an Economic Theory of Federal Jurisdiction," 6 Harv.J.L.&. Pub. Pol. 41 (1982) and Frank Easterbrook's "Antitrust and Federalism," - J.L.& Econ. 23 (1980), both of which deal similarly with analagous issues in related areas.

(4) the potential costs of regulatory capture;

(5) the effectiveness of "voting with your feet;" and

(6) the existence of important external effects.

Our analysis suggests that all but the last of these six factors, in general, support a conclusion that the more decisionmaking is decentralized, the better. Indeed, where the arguments for decentralization have force, they usually imply that local, or even individual decisionmaking is superior to state decisionmaking. Parenthetically, it is an interesting question whether federal preemption of state authority that leads to deregulation, and thus to an enhanced role for individual decisionmaking, should be characterized as more or less decentralized decisionmaking. For those cases in which preemption leads either to forbearance or to adoption of policies that permit greater reliance upon market forces, there may be perhaps an unexpected synergy between arguments for greater decentralization of decisionmaking and those for federal preemption premised on the existence of external effects.

Let us briefly go through the six arguments.

First, with respect to the production and use of information, state authorities may be expected to be more familiar with local conditions affecting supply and demand because they are literally closer to them than are their counterparts in the national government. Considerations related to the cost of acquiring relevant information thus appear to favor decentralization.

The second point is closely related to the first and involves the matching of public good outputs with consumer preferences.

In well functioning markets, there usually exists a fairly close match between consumer preferences and the outputs of private goods. The nature of public goods, however, is such that the desired close match of supply with demand is often impossible to achieve. For example, while opinions about appropriate defense policy vary, we can, in fact, have only one national defense policy at any point in time. An "average" or "compromise" policy will necessarily leave both hawks and doves unhappy to the extent that actual policy deviates from their preferred policy. The same is true of regulatory policies.

While the inability of public goods to satisfy consumer preferences as closely as private goods partially inheres in their nature, there may sometimes be opportunities for achieving a closer match of output with demand. In particular, if there are significant regional differences in consumer preferences, supply capabilities or environmental conditions, more decentralized supply of the relevant public good may lead to net gains in economic welfare. For example, to meet federally mandated auto emission standards, new automobiles generally are equipped with catalytic converters.

In a sparsely populated, relatively pollution-free state, catalytic converters produce few benefits but impose significant costs. If states instead of federal authorities were to set minimal auto emission standards, it would be possible to apply more stringent standards to automobiles sold in areas with air quality problems, like Los Angeles, while citizens of states like North Dakota could avoid what are for them unnecessary costs.

The third argument is the familiar idea of the states supplying a social laboratory.

When the most efficient policy response to a particular problem or change is unknown, a good way to discover it is to compare the effects of different solutions adopted by different policies. No one has a monopoly on good ideas. To make effective use of competition as a discovery tool requires only that there be a pool of different policy experiments from which to choose. A centralized authority might consider different responses to a particular problem, but it would have to create these alternatives itself and its imaginative capacity is inherently limited. Moreover, since there are constraints on its ability to experiment, and thus to gain experience with alternatives, its evaluation of relative costs and benefits must be based more upon speculative comparisons than actual experience. Ignorance and uncertainty about the effects of different public policies thus provide another reason to prefer decentralization.

The fourth argument concerns the potential for regulatory capture.

As is well known, regulation may be exploited to achieve ends that differ from those for which it is instituted. Subversion of regulation (or simply bad regulation) can occur for many reasons, but one of the most frequently discussed failure modes is "regulatory capture."

Regulatory capture is not a free good. Indeed, for consumers it is not even a "good." Capture normally requires an investment of resources to meld a controlling coalition of interests. The costs of forming such a coalition usually vary directly with the size of the relevant polity. This is true because, whatever the required degree of control, the larger the number of separate interests that must be reconciled, the more costly it will be to create and maintain a controlling coalition. This suggests that the costs of creating and maintaining an effective coalition will, in general, be greater at the national level than at state or local levels, and, therefore, that the probability of forming such a coalition at the national level will be smaller.

On the other hand, the return from successfully forming an effective coalition will, in general, be greater at the national level. Expected consumer losses from regulatory capture depend on both the magnitude of the losses that capture might impose and the probability that capture will occur. Thus, while the probability of capture may be smaller at the

national level, the losses that could arise from capture would be greater than those expected at the state level. Intuition suggests that the expected loss from a national monopoly would exceed the costs imposed by regulatory capture at the state level; but, following Posner (op. cit.), suppose for purposes of argument that expected losses from regulatory capture were, in fact, the same at the state and federal levels of goverment. Because expected losses at the federal level reflect small[er] probabilities of large[r] losses, a person who is averse to risk will attach greater disutility to that outcome than to an actuarially equivalent outcome involving larger probabilities of smaller losses. Risk aversion implies that the relative certainty of smaller losses is preferred to the uncertain (i.e., risky) prospect of potentially large losses. Assuming that consumers as a group are risk averse, decentralized decisionmaking is thus preferred.

The fifth point can be summarized under the rubric "voting with your feet".

"Voting with your feet" describes the idea that individuals or firms may be able to shape government policies by choosing or threatening to enter or exit a political jurisdiction. In an economic market, actual or potential competition from other sellers constrains the behavior of individual sellers. Similarly, the behavior of governments in the political market may be constrained by actual or potential competition from other governments for citizens, either individual or corporate.

The conditions under which voting with your feet can effectively constrain governments to adopt laws most beneficial to the population are quite stringent. The requirements for effective jurisdictional competition are:

(1) resource mobility;

(2) a large number of alternative jurisdictions;

(3) jurisdictional freedom to adopt any desired set of laws;

(4) absence of important extrajurisdictional (i.e., external) effects.

Not surprisingly, these conditions bear a close resemblance to those usually posited as requirements for the optimality of market organization. In economic markets, the absence of close substitute products or sources of supply combined with barriers to resource mobility can convey market power and may lead to an economically inefficient allocation of resources. Similarly, in political markets, resource immobility and the absence of meaningful jurisdictional alternatives can combine to produce inefficient laws.

Because it is more difficult to emigrate than to move from one state to another, and since the states are presumptively closer substitutes for

one another than are other countries for the United States, voting with your feet will generally prove a more effective disciplining mechanism when decisionmaking authority resides with the states rather than with the national government. This suggests an additional reason to prefer decentralized decisionmaking for setting policy.

The last and, as it turns out, an important countervailing argument rests on the existence of external effects, or what may be referred to in the instant context as extrajurisdictional effects.

If there are significant externalities, neither market competition nor political competition will produce optimal outcomes. Analogous to the factory owner who is not responsible for his pollution, state regulatory commissioners who are not responsible for the effects of their policy decisions on the residents of other states may make decisions that reduce economic welfare in the nation as a whole below what it would be if jurisdictional boundaries were drawn so as to control for the extra-jurisdictional effects.

In telecommunications, the extrajurisdictional effects that provide the putative economic rationale for federal preemption of state regulatory policies lie principally in economic interdependencies or complementarities that arise on either the demand side or the supply side of the market. For example, telephone, cable, cellular, microwave, and other kinds of communications companies are all capable of supplying local access or message distribution services subject to state regulation. Those local services are demand complements to the interstate long-distance voice, data, or video transmission services that are subject to federal regulation. State actions limiting competition in the supply of a telephone service subject to state regulation might thus reduce the effectiveness of competition in markets for complementary telephone services subject to federal regulation, if for no other reason than that the demand for the federal service might be reduced leaving less room for competitors. Whether state restraints will in fact adversely affect competition in complementary markets will depend, inter alia, on the stringency of the restraint, the availability of substitutes for the trade-restrained good, the degree of complementarity between the goods, and the size of the market for the complement relative to the minimum efficient size of firms supplying that good.

Supply-side complementarities arise when there are cost savings associated with jointly supplying different goods, as might be the case in telecommunications, for example, when the capital equipment that telephone companies use to supply interstate long-distance service can also be used to supply intrastate long-distance service. A firm permitted to offer both services may well achieve lower costs than a firm that is not allowed to offer both services. Thus, state regulations limiting intrastate long-distance competition may well have spillover effects that raise costs and reduce competition in the interstate market.

So, notwithstanding the benefits of jurisdictional competition, there clearly is a danger in drawing jurisdictional boundaries too narrowly. The likelihood that a political agent's decisions have impacts beyond his jurisdiction increases as jurisdictional boundaries shrink. This presents the fundamental problem of a federal system of governance--how can a preference for decentralized decisionmaking be reconciled with the adverse consequences flowing from policies that ignore the important economic interdependencies linking those within and those beyond the boundaries of the decisionmakers' jurisdiction. Logically, the way to internalize external effects is to redraw jurisdictional boundaries so that what was once external becomes internal.

In economic terms, optimal internalization of externalities does not necessarily require complete internalization. For example, zero air pollution, if feasible, might certainly be deemed highly valuable. It would not, however, be economically optimal because pollution abatement is not a free good. Pollution abatement is a valued good, but because it is also a scarce good, other valued goods must be foregone to achieve greater pollution abatement. At some point, the additional benefits of greater pollution abatement are presumably more than offset by the value of what must be foregone to achieve them.

In terms of jurisdictional externalities, the foregoing analysis suggests by analogy that complete internalization through federalization of decisionmaking for telecommunications policy might not be desirable. Like pollution abatement, internalization of jurisdictional externalities is not a free good. It comes at a cost. That cost includes the loss of the advantages, already discussed, that more decentralized decisionmaking can bring. These advantages are necessarily forfeited when jurisdictional boundaries are enlarged. But, of course, leaving telecommunications policy decisions entirely to state commissions may not lead to optimal results either. Such a course of action would impose the costs created by each failure to internalize relevant jurisdictional externalities.

If the decisionmaking process itself were costless, our analysis might suggest that case-by-case cost-benefit analysis should be used to identify the optimal allocation of decisionmaking authority. When the costs of decisionmaking are taken into account, such a case-by-case approach appears much less likely to produce desirable outcomes.

First, cost-benefit analysis can produce efficient outcomes only if it is possible to measure costs and benefits accurately. There are important differences between legal and market processes as means of valuing resources. Colloquially speaking, markets perform the quantitative analysis by requiring that people "put their money where their mouths are;" willingness to pay (or discount) generally imparts greater credibility to a claim of superior value (or efficiency) than does forensic energy. Posner has argued that the deficiencies of legal valuation techniques compared to

market valuation techniques make it desirable, so far as is consistent with achieving efficient use of resources, to minimize the need for cost-benefit analysis in legal decisions.[2]

Second, a cost-benefit approach must be consistently applied to produce consistent results. Too many variables associated with its application make the achievement of consistency very unlikely. It seems highly likely that different judges or panels of judges might attach different weights or significance to the different consequences of particular actions. Even the same judge might on different occasions view the same set of facts differently. Moreover, it is likely that the quality and quantity of evidence presented in different forums will vary over time. Taken together, all these factors could easily lead to inconsistent decisions, that is, to unlike judicial treatment in like circumstances.

Third, performing a cost-benefit analysis is likely to consume more time and resources than applying a more categorical rule. A simple rule that assigns policymaking authority solely on the basis of whether significant external effects exist, would, for example, be less burdensome to apply than cost-benefit test.

The economies of the simpler rule may not come without cost, however. The price paid for simplicity and ease may be an increase in the number of assignments it makes that are less than optimal. There may actually be cases where adverse external effects exist, but where these are more than offset by internal benefits. A rule that renders decisions solely on the basis of whether there are adverse external effects thus risks making the wrong decision in some cases. That sacrifice in accuracy may be well worth making, however, if mistakes are relatively rare and insignificant, and the cost savings attending the simpler rule are substantial both in terms of conserved resources and the timeliness with which decisions can be rendered.

Legal Analysis

Historically the Commission and the courts have treated the question of how power is to be shared under the Communications Act of 1934 as solely a legal issue, one to be resolved using legal analysis. There has been little if any effort to use techniques or insights from other disciplines to identify where the balance of power should be struck. In particular, the courts have never explicitly applied the principles of economic analysis discussed in our paper to decide whether preemption should be upheld. Thus it seems all the more amazing that, at least until the 1986 Supreme Court decision in Louisiana Public Service Commission v. FCC,[3] the courts, for

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2 R. Posner, Economic Analysis of Law (1975).

their own legal reasons, seemed to reach outcomes consistent with the economic principles already outlined, in particular, the idea that preemption, in general, should be premised on the existence of important extrajurisdictional effects.

As enacted in 1934, Section 2(a) of the Communications Act[4] gave the FCC plenary authority to set interstate telecommunications policy. In equally unequivocal terms, Section 2(b)[5] reserved the states' authority over intrastate policy. For forty years the two levels enjoyed peaceful co-existence. They agreed that the industry they regulated was a natural monopoly and their goal was to protect universal telephone service.

By the mid-1970's, however, technological advances had irrevocably altered the telecommunications industry. Developments in computer technology especially had, not only increased the kinds of communications services telcos could offer their customers, but also blurred the differences between data processing and communications. These advances, coupled with the regulatory commitment to subsidizing local service rates, combined to give new suppliers both the incentive and the ability to challenge the monopoly.

One of the first casualties of these developments was the harmony between state and federal regulators. They disagreed on how they should respond to the rapidly changing characteristics of the industry. Policy disagreements led, in turn, to court battles in which the FCC pointed to the broad language of Sections 1[6] and 2(a) of the Communications Act, claiming that these provisions gave it paramount authority to set the policies to govern the areas of dispute. States answered that Section 2(b) shielded their regulatory authority from federal intervention. The courts became the final arbiter of where the power lay.

In our paper we examine recent case law resolving such jurisdictional disputes between the FCC and state public service commissions, and identify the assumptions, both explicit and implicit, underlying the legal reasoning the courts present to justify their holdings. We wanted to see if there was anything in the reasoning or assumptions that underlay the Lousiana decision that distinguished it from the cases that had preceded it; anything that might explain why the Lousiana opinion rejected a trend, readily

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3 476 U.S. 355 (1986)

4 Codified at 47 U.S.C. Section 152(a).

5 Codified at 47 U.S.C. Section 152(b).

6 Codified at 47 U.S.C. Section 151.

discernible in earlier cases, toward authorizing increased centralization of telecommunications policymaking.

What we conclude is that in Louisiana, the Supreme Court appears to have approached the task of statutory interpretation in a way markedly different from that of appellate courts resolving earlier preemption disputes. It appears to view both the nature of the Communications Act and its own role in interpreting that legislation quite differently from the courts deciding earlier cases. To illustrate our point, we examine some of those earlier cases, and then contrast them with the Louisiana opinion.

We focus upon four cases all dealing with regulation of customer premises equipment. In the first two cases, the North Carolina Utilities Commission had challenged FCC decisions liberalizing the terms under which customers could attach CPE not provided by their telephone company to the network. In the first case,[7] the FCC had preempted state regulations that might conflict with its decision to permit subscribers to connect customer-provided CPE to the public switched network through protective coupling devices. The devices were themselves provided by the telcos under tariff. In that case, the court established the following rule for identifying the common carrier activities over which state commissions retained regulatory power: (1) they had to be local in nature and (2) they could not substantially affect the development or conduct of interstate communications. The latter standard might be characterized as the legal version of an externalities standard. The court singled out as inviolable the state's power to regulate local rates. The court found that the FCC's decision to permit attachment of customer provided CPE through a protective device had too indirect an effect on state ratemaking power to run afoul of the limit on federal authority. If the states were upheld, however, the physical inseparability of CPE used for interstate and intrastate purposes would have frustrated, if not nullified, the FCC's efforts to promote competition in the CPE market.

In the second case,[8] the North Carolina Commission challenged the FCC's then new Part 68 program, which eliminated the need for the coupling devices. Applying the test set forth in the first North Carolina case, the court upheld the FCC plan, again finding its effects on states' powers to keep local rates low were too indirect to void the preemption.

A third case illustrates how the courts' interpretation of the Communications Act continued to become increasingly permissive of

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7 North Carolina Utilities Commission v. FCC, 537 F. 2d 787 (4th Cir), cert. denied, 429 U.S. 1027 (1976).

8 North Carolina Utilities Commission v. FCC, 552 F.2d 1036 (4th Cir.), cert. denied, 434 U.S. 874 (1977).

preemption. In Diamond International,[9] the court upheld the FCC's decision not to preempt state tariffs. The tariffs at issue had required the appellant to pay a surcharge for its leased PBX, arising from its use as part of a private interstate network. Citing the earlier North Carolina cases, the court found no evidence that the surcharge would substantially affect the conduct or development of interstate communications. In dictum, however, it added that in certain circumstances, even state control over local ratemaking was not immune from federal preemption.

The last of the four cases is CCIA v. FCC,[10] in which the FCC's decisions reached in the Second Computer Inquiry were affirmed. In particular the decision to deregulate the provision of CPE by telephone companies and the preemption of state regulation in conflict with that decision were upheld against vigorous attack by state regulators. The FCC had relied on Title I powers to deregulate CPE, thus the federal policy frustrated here was one designed to further the general public interest goals set forth in Section 1 of the Act. The case is replete with dicta indicating that "state regulation which impedes a federal regulatory goal must yield to the federal scheme."[11]

The court in CCIA stated that it found no reason to regard state ratemaking as more shielded from preemption than other state activities. From the first North Carolina case to the CCIA case, the law governing FCC preemption had evolved to a point at which it imposed little practical restraint on federal policy initiatives. Short of the Commission's actually prescribing rates for intrastate services, it appeared unlikely that the courts would reverse a Commission decision to preempt a state policy that conflicted with its federal policy goals.

It was in this setting that the Commission after some equivocation decided that the states would be required to use FCC prescribed capital recovery schedules for intrastate ratemaking purposes. In 1983 the FCC preempted state authority to prescribe other rules for calculating the depreciation expense that telephone companies could recover through rates for intrastate services.[12] To support its preemption, the FCC asserted

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9 Diamond International Corp. v. FCC, 627 F.2d 489 (D.C. Cir. 1980).

10 693 D.2d 198 (D.C. Cir. 1982), cert. denied sub nom. Louisiana Public Service Commission v. FCC, 461 U.S. 938 (1983).

11 See, e.g., 693 F.2d at 215; id. at 216.

12 See Amendment of Part 31, Uniform System of Accounts for Class A and Class B Telephone Companies of the Commission's Rules and Regulations with respect to accounting for station connections, optional payment plan revenues and related capital costs, customer premises equipment and sale of terminal equipment, CC Docket No. 79-105, 92 ECC 2d 864 (1983).

that Section 220 of the Communications Act explicitly authorized such preemption. It added that preemption was necessary to prevent the states from frustrating a federal policy designed to meet the statutory goal, set forth in Section 1, of an efficient nationwide communications service at reasonable rates. Slower capital recovery schedules prescribed by the states would interfere with the development of competition in interstate service markets.

On appeal the Fourth Circuit agreed with the FCC's Section 1 rationale. They said that Section 2(b)'s "reservation [of power] is not to be read as preserving the states' sphere of intrastate jurisdiction at the expense of an efficient, viable interstate telecommunications network."[13] If state rules for depreciation accounting might endanger that objective, they had to give way.

Then, for the first time in fifty years, the Supreme Court chose to examine how Congress had allocated between the FCC and the states the power to prescribe depreciation rates. Declining to accept the rules developed by the lower courts for answering preemption questions under the Communications Act, the Court performed its own de novo examination of the Act's legislative history. The language and reasoning of the resulting opinion strongly suggests that the Court here did not accept the traditional view, reflected in the earlier opinions we have discussed, that courts were to reconcile inconsistent provisions within a statutory scheme in order to give effect to the public interest goals stated in the act. A public choice theory view of the legislative process and the court's role as an agent of that process appears to have shaped the court's analysis.

The Court interpreted Section 152(b) as "fenc[ing] off from FCC reach or regulation" intrastate common carrier service. Section 1 of the Communications Act could not authorize an FCC breach of that fence. The decision suggests that only in the face of physical inseparability could preemption become possible, and then only if one of the Commission's explicit Title II powers would be frustrated. Read literally, Louisiana suggests that if FCC and state regulation can possibly co-exist, preemption is foreclosed, even if the result is less than optimal. Said another way, even if a given state policy would adversely affect either incentives or abilities to offer or to subscribe to an economically efficient interstate service offering, this is not a factor to be weighed in determining whether the FCC may preempt that state policy. Externalities per se play no role under the Louisiana rule.

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13 Virginia State Corp. Commission v. FCC, 737 F.2d 388, 392 (1984), revers'd sub nom. Louisiana Public Service Commission v. FCC, 76 U.S. 355.

Initially Louisiana was hailed as reestablishing the badly eroded right of state regulators to set telecommunications policy within their state boundaries. And, indeed, the first judicial and FCC reactions to the opinion seemed to support this conclusion.[14] With the passage of time, however, the FCC has apparently decided that Louisiana imposes less of a limitation than it first thought. Decisions to preempt in the ARCO[15] proceeding and Computer Three have led to renewed battle in the courts over the scope of federal authority to set telecommunications policy. Only as the appellate courts interpret and apply Louisiana to specific fact situations like those posed by ARCO and Computer Three[16] will we be able to discern Louisiana's long term significance. It may signal a redistribution of the power state and federal regulators hold to define this nation's telecommunications policies. On the other hand it may be merely an isolated detour from a path winding inevitably toward judicial nullification of Section 2(b). Only time will tell.

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14 See, e.g., California v. FCC, 798 F.2d 1515 (D.C. Cir. 1986); Cox Communications, Inc., 1FCC Rcd 561 (1986), vacating as moot Cox Cable Communications, 102 FCC 2d 110 (1985).

15 Atlantic Richfield Company, Mimeo No. 1115, released Nov. 27, 1985, application for review denied, 64 RR 2d (P&F) 1535 (1988).

16 Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry) CC Docket No. 85-229, 104 FCC 2d 958 (1986) (Phase I) recon., 2 FCC Rcd 3035 (1987), appeal pending sub nom. California v. FCC, Case No. 87-7230 (9th Cir.), further recon., 3 FCC Rcd 1135 (1988); 2 FCC Rcd 3072 (1987) (Phase II), appeal pending sub nom. California v. FCC, Case No. 87-7230 (9th Cir.) recon. 3 FCC Rcd 1150 (1988).